No. 82-1483

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

SIMONE C. ANDRE,

Petitioner,

—against—

MERRILL LYNCH READY ASSETS TRUST, MERRILL LYNCH ASSET MANAGEMENT, INC., MERRILL LYNCH, PIERCE, FENNER & SMITH, INC. and IRVING L. GARTENBERG,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF OF RESPONDENTS MERRILL LYNCH READY ASSETS TRUST, MERRILL LYNCH ASSET MANAGEMENT, INC. and MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED IN OPPOSITION TO THE PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Did the Court below err in holding that plaintiffs had failed to prove a breach of fiduciary duty under Section 36(b) when the record demonstrated that the trustees of the Fund were fully informed of all material

facts, the shareholders had approved the fee agreement after full disclosure, the services performed by the adviser were exemplary, and the amount of profit earned by the adviser was not excessive?

2. Did the Court below err in holding that the costs incurred by the broker affiliate of the adviser in processing orders for the purchase and sale of Fund shares could properly be considered in determining the fairness of the advisory fee in light of the fact that Congress specifically stated that all services rendered were to be considered?

3. Did the Court below err in holding that the adviser had satisfied its duty to supply the Trustees with all material facts relevant to their consideration and negotiation of the advisory fee?

4. Did the Court below err in holding that the shareholders of the Fund had properly approved the fee where the information which Petitioner suggests should have been provided was not material to a reasonable investor in making his decision to purchase and sell shares of the Fund?

PARTIES TO THE PROCEEDINGS BELOW

All of the parties appearing in the District Court and the Court of Appeals are listed in the caption.*

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* Respondents Merrill Lynch Asset Management, Inc. and Merrill Lynch, Pierce, Fenner & Smith Incorporated are wholly-owned subsidiaries of Merrill Lynch & Co., Inc., a publicly-held financial services company.

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STATEMENT OF THE CASE

Statement of Facts

This action involves an alleged breach of fiduciary duty with respect to the receipt of compensation under Section 36(b) of the Investment Company Act of 1940, 15 U.S.C. § 80a-35(b) (the "Act"), brought by a shareholder ("Petitioner") of the Merrill Lynch Ready Assets Trust (the "Fund").

The Fund is a no-load money market mutual fund that invests primarily in short-term money market securities.* The Fund is the largest money market fund registered under the Act since the inception of such funds, approximately ten years ago. At the time of trial, its assets were in excess of $19 billion and it had over one million shareholders.

The Fund is managed by Merrill Lynch Asset Management, Inc. ("MLAM" or the "Adviser"). MLAM is compensated for its services pursuant to an investment advisory agreement with the Fund which contains a descending schedule of fees based upon the size of the Fund's assets, the effective rate of which is one of the lowest in the money market mutual fund industry.

Orders for the purchase and sale of shares of the Fund are processed in large part by an affiliated company, Merrill Lynch, Pierce, Fenner & Smith Incorporated ("MLPF&S" or the "Broker"). At the time of trial,

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* *E.g.*, short-term United States Government securities; Government agency securities; bank certificates of deposit and bankers' acceptances; short-term corporate debt securities such as commercial paper and variable amount master demand notes; and repurchase and reverse repurchase agreements.

MLPF&S processed an average of more than 30,000 shareholder orders per day for the purchase and redemption of shares of the Fund.

The Fund, MLAM, and MLPF&S ("Respondents") have all been joined as defendants in this action.

During the period involved in this suit, the Fund was governed by a Board of Trustees consisting of eight persons. Two of the Trustees were affiliated with either MLAM or MLPF&S; the remaining six were neither "affiliated" nor "interested" persons of any Merrill Lynch company. 15 U.S.C. §§ 80a-2(a)(3) and (19). (These Trustees are hereinafter referred to as the "independent Trustees.") The Board of Trustees held regular meetings four times each year (and special meetings as required), and at its regular spring meeting considered an investment advisory agreement, including a fee schedule, proposed by MLAM. Prior to that meeting, MLAM provided to each of the Trustees, in written form, extensive information relevant to their consideration of the proposed agreement. Moreover, immediately prior to full Board consideration of the proposed agreement, the independent Trustees, who comprised an audit committee, met separately to consider the proposal. In this and all other matters, the independent Trustees were advised by separate counsel.

A number of Merrill Lynch affiliated companies provided services to the Fund and its shareholders. MLAM, the investment adviser, selected the Fund's investments, traded in money market securities for the Fund's account, performed administrative and management services for the Fund and its shareholders, and provided the Fund with office space, facilities, equipment, and personnel. In making its investment decisions, MLAM had access to the advice and expertise of all Merrill Lynch affiliates, and

particularly Merrill Lynch Economics, Inc. ("MLE"), Merrill Lynch Government Securities, Inc. ("MLGSI"), and MLPF&S. MLE provided basic economic research and forecasting; MLGSI was one of the largest dealers in United States Government securities and Government agency securities; MLPF&S, the largest registered broker-dealer in the United States, provided fundamental research on bank and other corporate issuers.

Although not required to do so, substantially all shareholders of the Fund established and maintained accounts at MLPF&S branch offices and placed their orders to purchase or sell shares of the Fund through one of MLPF&S's more than 7,000 account executives. Purchases of Fund shares could be effected conveniently and expeditiously by delivery of a check to an account executive at any one of MLPF&S's more than 400 domestic offices or by instructing the account executive to purchase Fund shares with the cash proceeds of other securities transactions; redemptions of Fund shares could be made with similar efficiency by requesting the account executive to have a check prepared for pickup or mailing on the day after the redemption order was effected.* Shareholders could also obtain current information from their respective account executives concerning the status of their Fund shareholdings and the current yield of the Fund. The costs incurred by the Merrill Lynch organization in providing such services were substantial.

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* Transactions could also be effected directly through the Fund's Custodian and Transfer Agent, The Bank of New York. Through the Transfer Agent, shareholders could also write checks payable directly from their Fund shareholdings. As the Court below recognized, however, "[t]he services rendered to shareholders by the Merrill Lynch organization, . . . greatly exceeded those that could be furnished by the Bank of New York, which performs the duties required of it as Transfer Agent under its agreement with the Fund at only one main office located in New York City." 694 F.2d at 932; Apdx. A20.

For all these services, MLAM charged the Fund a fee based upon a percentage of the average daily value of the Fund's net assets, and graduated downward as those assets increased. This rate was the product of a series of negotiations between the independent Trustees and MLAM. During the period from 1977 to 1979, these negotiations led to reductions in the effective rate as the assets of the Fund increased. At the time of trial, the schedule called for a fee of 0.50% of assets under $500 million, and for intermediate breakpoints as the Fund's assets increased, down to 0.275% for assets in excess of $2.5 billion. As a result, the effective fee at the time of trial was 0.288%, or $2.88 for every $1,000 invested—one of the lowest in the money market mutual fund industry.

The Proceedings Below

This action commenced on October 18, 1979, when petitioner filed a complaint asserting a cause of action under Section 36(b) of the Investment Company Act. The action was consolidated with *Gartenberg* v. *Merrill Lynch Asset Management, Inc.*, another shareholder action already pending and similarly alleging violations of Section 36(b).

Plaintiffs' claims were tried before Judge Milton Pollack in the Southern District of New York in September, 1981.* After a full trial on the merits, Judge Pollack, in a 66-page decision, held that plaintiffs had failed to prove a breach of fiduciary duty:

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* Petitioner and plaintiff Gartenberg completed their direct case in about three hours. They did not call a single fact witness, but relied solely on two purported expert witnesses and documentary evidence largely produced by respondents. Both witnesses testified in conclusory terms that, in their view, the fees being paid by the Fund to MLAM were "excessive" and "unreasonable".

> A critical examination of the actual and relevant facts concerning the issue of whether the compensation received by MLAM constituted a breach of fiduciary duty exposes the unreality and invalidity of each of plaintiffs' contentions.

Gartenberg v. *Merrill Lynch Asset Management, Inc.*, 528 F. Supp. 1038, 1044 (S.D.N.Y. 1981); Apdx. A51, *aff'd*, 694 F.2d 923 (2d Cir. 1982).*

On appeal, the Second Circuit unanimously affirmed Judge Pollack's decision, concluding that plaintiffs had failed to prove any breach of fiduciary duty. *Gartenberg* v. *Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982). The Second Circuit held that the proper test under Section 36(b)

> is essentially whether the fee schedule represents a charge within the range of what would have been negotiated at arm's length in the light of all of the surrounding circumstances. . . . To be guilty of a violation of § 36(b), therefore, the adviser-manager must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining.

694 F.2d at 928; Apdx. A12-A13 (*citing Fogel* v. *Chestnutt*, 668 F.2d 100, 112 (2d Cir. 1981), *cert. denied*, 103 S. Ct. 65 (1982); *In re Gartenberg*, 636 F.2d 16, 18 (2d Cir. 1980), *cert. denied*, 451 U.S. 910 (1981)). The Second

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* The District Court's opinion is officially reported at 528 F. Supp. 1038 (S.D.N.Y. 1981), and is reprinted in the Appendix to the Petition at pages A27-A163.

The Opinion of the Court of Appeals is officially reported at 694 F.2d 923 (2d Cir. 1982), and is reprinted in the Appendix to the Petition at pages A1-A25.

"Apdx." refers to the Appendix to the Petition for a Writ of Certiorari.

Circuit cited several factors as "important" in determining whether a breach of fiduciary duty in respect of compensation had occurred. These factors, recognized by the District Court, included (1) the adviser-manager's cost in providing the service, (2) the nature and quality of the service, (3) the extent to which the adviser-manager realized economies of scale as the Fund grew larger, (4) the volume of orders that were processed by the manager, (5) the expertise of the independent trustees of the Fund, (6) whether the trustees were fully informed about all facts bearing on the adviser-manager's service and the fee, and (7) the extent of care and conscientiousness with which the trustees performed their duties. 694 F.2d at 929-30; Apdx. A15-A16.

Applying these standards to the facts developed at trial, the Second Circuit concluded that plaintiffs had failed to sustain their burden of proving that the fee charged the Fund by MLAM constituted a breach of fiduciary duty under Section 36(b).

> [P]laintiffs have failed to meet their burden of proving that the fees charged by the Manager to the Fund were so excessive or unfair as to amount to a breach of fiduciary duty within the meaning of § 36(b). There is no evidence that the services rendered by the Manager have not been of the highest quality, bringing to bear the expertise and facilities of the huge, far-flung Merrill Lynch organization. The average investor in the Fund, while not realizing the highest possible yield for his investment, has enjoyed a better-than-average return.

694 F.2d at 930; Apdx. A17.

The Second Circuit noted that the increase in the Adviser's fee resulted from the tremendous increase in the size of the Fund. The Court, however, noted that "[t]his

increase multiplied the number of customers, daily transactions and other activities which the [Adviser] and the Merrill Lynch organization handled as part of the service for the fee, thereby increasing costs proportionately." 694 F.2d at 930; Apdx. A17-18. Although Petitioner had argued that costs incurred by MLPF&S should not be considered in evaluating the fee, the Court concluded that "[s]ince the Manager [MLAM] and Broker [MLPF&S] were divisions of one economic unit, the district court was entitled to deduct these costs in calculating the Manager's net profits." *Id.* at 931; Apdx. A18.

Finally, the Court below held that the Trustees, who "were represented by capable, independent counsel [and] were found to be competent, independent and conscientious" (694 F.2d at 926; Apdx. A8) were "aware of or could obtain the essential facts needed to negotiate a reasonable fee." 694 F.2d at 933; Apdx. A23. As to Petitioner's argument that there should be offset against the costs of MLPF&S the so-called "fall-out benefits" which might have been obtained, the Court below noted that the Trustees had been fully advised concerning the possible existence of such benefits, although the exact amount had not been quantified. Further,

> the burden was on appellants, not the defendants, to adduce evidence demonstrating that the benefits were so substantial that they rendered the Manager's fee so disproportionately large as to label its negotiation a "breach of fiduciary duty" within the meaning of § 36(b).

694 F.2d at 932; Apdx. A22.

SUMMARY OF ARGUMENT

The Petition raises no issue warranting review by the Court. After fully considering the issues, the Court of Appeals correctly decided that the costs of the Adviser and its affiliates should be considered in determining the reasonableness of the investment advisory fee; that Petitioner had failed to prove a breach of fiduciary duty with respect to the receipt of compensation; and that the Trustees and shareholders of the Fund were supplied with all relevant information in connection with their consideration of the fee. No further review is justified.

REASONS WHY THE WRIT SHOULD NOT BE GRANTED

This case does not present the issues so fancifully stated in the Petition for Certiorari. Contrary to Petitioner's assertions, the Court of Appeals did *not* hold that the fiduciary duty owed by an adviser of a mutual fund to the fund in respect of the receipt of compensation is now less than that owed prior to 1970; it did *not* hold that the duty of disclosure to such shareholders in connection with compensation is less than that mandated even under the common law; and it did *not* hold that Section 36(b) eliminates the protections to shareholders of such funds afforded by the fiduciary duty of full disclosure.

In fact, the decision of the Court of Appeals places heavy burdens of disclosure on investment advisers and assures full consideration of all factors relevant to the receipt of compensation by Fund trustees. Moreover, the Court of Appeals held that even full disclosure did not insulate a fee arrangement between the Fund and its adviser from attack if the fee itself was found to be higher

than that which would be expected from arms-length bargaining.

A reading of the decision below, as well as the District Court opinion, establishes that the courts below were meticulous in affording to shareholders all possible protection against a breach of fiduciary duty. In this connection, it is significant that Gartenberg, whose counsel had been designated as lead counsel to supervise and coordinate all pretrial proceedings for plaintiffs in these actions and who, in fact, was lead counsel throughout, did not apply for certiorari to this Court or join in the present application. It is only Petitioner, whose role throughout the case was secondary, who seeks to attack the judgment below.

I

THE COURT BELOW CORRECTLY CONSIDERED PROCESSING COSTS IN DETERMINING THE REASONABLENESS OF THE ADVISORY FEE

The Petition asserts that the Court below erred in considering the costs incurred in connection with the processing of orders for the purchase and sale of Fund shares in evaluating the excessiveness of the Adviser's fee under Section 36(b). Under the facts of this case, however, the costs incurred by MLPF&S, an affiliate of the Adviser, in processing the enormous volume of purchases and redemptions of Fund shares were properly included in determining the fairness of the fee.

In evaluating whether an advisory fee is so excessive as to constitute a breach of fiduciary duty under Section 36(b), the Court must look at all services provided to the Fund and the costs associated with the provision of those services. The statute itself speaks of payment for the

services of the adviser "or any affiliated person of such investment adviser." 15 U.S.C. § 80a-35(b). The legislative history to Section 36(b) confirms that courts should consider costs of services rendered by affiliates as well as those performed by the adviser. The Senate and House Reports both note:

> [I]t is intended that the court look at all the facts in connection with the determination and receipt of . . . compensation, including all services rendered to the fund or its shareholders.

S. Rep. No. 91-184, 91st Cong., 2d Sess. 15 (1969), *reprinted in* [1970] U.S. Code Cong. & Ad. News 4897, 4910; H.R. Rep. No. 91-1382, 91st Cong., 2d Sess. 37 (1970).

The District Court found that the processing of orders and other services provided by the Broker constituted "an essential portion of the total package of services that may properly be compensated by the advisory fee." 528 F. Supp. at 1050; Apdx. A76. Similarly, the Second Circuit observed that the Adviser and Broker "were divisions of one economic unit. . . . To limit consideration to the [Adviser's] own administrative expenses would be to exalt form over substance and disregard the express Congressional intent that 'all the facts in connection with the determination and receipt of such compensation' be considered." 694 F.2d at 931; Apdx. A18.

The Petition suggests that consideration of processing costs is somehow inconsistent with a statement in the Fund Prospectus that the Broker has waived certain compensation. (Pet. at 26-29). The fact that the Broker imposes no sales charge and the Prospectus disclosure of that fact in no way suggests the conclusion that, in assessing the fairness of the fee, the Broker's administra-

tive and processing costs should not be considered as part of the costs being incurred by the "one economic unit" providing services to the Fund.

The Petition also erroneously claims that the Broker's processing costs constitute distribution expenses that are not properly chargeable to the Fund. (Pet. at 29-39). This contention is incorrect as a matter of fact and law. The SEC has defined "distribution expenses" as those expenses incurred:

> directly or indirectly in financing any activity which is *primarily intended* to result in the sale of shares issued by [an investment] company.

SEC Rule 12b-1, 17 C.F.R. § 270.12b-1(a)(2); Apdx. A182 (emphasis supplied). The Court below properly held that such "distribution expenses" are limited to promotional expenses such as advertising and sales literature designed to create new sales of no benefit to existing shareholders, and do not include administrative costs incurred in processing shareholder orders. 694 F.2d at 931 n.4; Apdx. A19 n.4; *see* SEC Rule 12b-1, 17 C.F.R. § 270.12b-1; Apdx. A182-86. Petitioner introduced no evidence at trial that there was any promotion of Fund sales by the Merrill Lynch organization. 694 F.2d at 931 n.4; Apdx. A19 n.4.

The Petition also asserts that the processing costs should be offset by any "fall-out benefits" accruing to the Merrill Lynch organization. (Pet. at 39-42). The Court below found, however, that the Trustees were aware of the existence of such potential benefits, and took them into consideration in evaluating the propriety of the investment advisory agreement. *See* 694 F.2d at 932; Apdx. A22, 528 F. Supp. at 1056-57; Apdx. A106-07. The Court below further held that Petitioner had failed to

adduce any evidence demonstrating that these benefits were so substantial that they rendered the Adviser's fee so disproportionately large as to constitute a "breach of fiduciary duty" under Section 36(b). 694 F.2d at 932; Apdx. A22.

Finally, Petitioner complains, in various diverse ways, of the fact that the Court of Appeals imposed on Petitioner the burden of proving a breach of fiduciary duty in respect to the receipt of excessive compensation, rather than imposing on defendants an obligation to negative the alleged breach. The Court of Appeals, however, did nothing more than the statute itself mandates:

> [T]he plaintiff shall have the burden of proving a breach of fiduciary duty.

15 U.S.C. § 80a-35(b)(1).

II

THE DECISION BELOW AFFORDS SUFFICIENT PROTECTION TO THE FUND'S SHAREHOLDERS

The Petition erroneously contends that Section 36(b) requires "that disclosure to the shareholders be equivalent to that made to the Trustees." (Pet. at 56). Carried to its logical conclusion, Petitioner's argument would require that the investment adviser supply each of the one million shareholders of the Fund with hundreds of pages of material identical to that supplied annually to the Trustees in connection with their consideration of the investment advisory agreement. Clearly, Section 36(b) imposes no such obligation.

Both the District Court and the Court of Appeals concluded that the Fund's shareholders were supplied

with all relevant information. *See* 694 F.2d at 933; Apdx. A23; 528 F. Supp. at 1056-57, 1065-67; Apdx. A106-07, A149-56. Petitioner has not shown anything to the contrary.

In this connection, contrary to Petitioner's assertion (Pet. at 16), the decision of the Court below is wholly consistent with the decision of that Court in *Tannenbaum* v. *Zeller*, 552 F.2d 402 (2d Cir.), *cert. denied*, 434 U.S. 934 (1977). In *Tannenbaum*, the Second Circuit concluded that proxy statements issued to a Fund's shareholders omitted to state material facts concerning opportunities to recapture portfolio brokerage commissions for the benefit of the Fund, and that "there was a substantial likelihood" that "disclosure of the fact that there were recapture opportunities which the Board had chosen to forego . . . would have assumed actual significance in a reasonable investor's deliberations concerning the management agreement." 552 F.2d at 434. Here, however, both the District Court and the Court of Appeals found that all material information was disclosed to the Trustees and to the Fund's shareholders. Consequently, petitioner has not and cannot cite to any decisions by this Court or any other court in conflict with the result reached by the Court below.

CONCLUSION

For the reasons set forth above and in the decisions below, the Petition for Certiorari should be denied.

Dated: March 31, 1983

Respectfully submitted,

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